

# 16 Real Estate Syndicates and Investment Trusts

## REAL ESTATE SYNDICATION

Real estate syndication offers the opportunity to channel private savings into real estate investments for which other financing is not available. It has been a popular method of financing the purchase and sale of properties in the higher price ranges.

The term “syndication” has no precise legal significance. It is a descriptive term for an organization or combination of investors pooling capital for investment in real estate. The responsibility, obligation and relationship of the syndicator to the investment group and the investors to each other are determined principally by the form of organization.

Real estate licensees have been active in real estate syndication for years. This follows naturally from licensees’ involvement as agents in purchase and sale transactions. When confronted with a listing or other opportunity to sell property requiring financing that could not be handled by a single purchaser, a real estate broker might turn to others for pooling of capital necessary to consummate the purchase.

### In General

A typical real estate syndication combines the money of individual investors with the management of a sponsor, and has a three-phase cycle: origination (planning, acquiring property, satisfying registration and disclosure rules, and marketing); operation (sponsor usually manages both the syndicate and the real property); and liquidation or completion (resale of the property).

### Benefits

Virtually every real estate broker or developer has been at some time in a controlling position with respect to an expensive piece of property that appears to offer extremely favorable opportunities for profit to the purchaser. All too often the investment outlay on such a purchase is more than any single client can manage. The real estate licensee who understands the methods of syndication can turn what would otherwise have been a frustrating and unrewarding situation into a profitable transaction for both the licensee and the investors.

By pooling limited financial resources with others who are similarly situated, a small-scale investor is afforded an opportunity to participate in ownership and operation of a piece of property that is too much to handle singly or in a joint venture with one or two others.

Syndication also offers professional management which might not otherwise be economically feasible for the small investor. Professional management, the basic commodity that the syndicator has to offer, is crucial to successful syndication.

### Syndicate Forms

Selecting the form of organization involves practical as well as legal and tax considerations. Each of the available entities has advantages and disadvantages. The corporate form insures centralized management as well as limited liability for the investors but is seldom utilized in modern syndicates because of its negative tax features. The general partnership (joint venture) avoids the double taxation normally involved in a corporate entity but the unlimited liability provision and lack of centralized

management militate against its use. The limited partnership combines nearly all of the advantages of the corporate and partnership forms. It has the corporate advantages of limited liability and centralized management and the tax advantages of the partnership. Consequently, the limited partnership form of organization is the one most frequently selected for real estate syndicates.

Another form of business, the limited liability company, was added in 1994 and includes liability limitation similar to that afforded shareholders of a corporation.

### **Limited Partnership**

Under the California Revised Limited Partnership Act, a limited partner is not liable as a general partner unless the limited partner is also named as a general partner in the certificate of limited partnership or the limited partner participates in control of the business (Corporations Code Section 15632). If the limited partnership agreement otherwise satisfies certain tax requirements, the limited partnership is taxed as a partnership rather than as an association taxable as a corporation.

### **Regulatory Control of Real Estate Syndicate Offerings**

The increasing use of syndicates to invest in real estate in California led to the enactment of the Real Estate Syndicate Act (Business and Professions Code Sections 10250, et seq.) in 1969. Operative January 2, 1970, this law was applicable only to noncorporate syndicates owned beneficially by 100 persons or less which were formed for the sole purpose of investing in real property. Jurisdiction over these offerings was transferred from the Department of Corporations to the Department of Real Estate. Jurisdiction over other syndicate offerings (e.g., oil and gas syndicates) remained with the Department of Corporations.

Effective January 1, 1978, the Real Estate Syndicate Act was repealed and the regulation of offerings of all real estate syndicate interests was again vested in the Department of Corporations.

A given form of business for pooling investment money may constitute a securities offering for which the organizers must seek a permit or exemption from the Department of Corporations.

The 1977 legislation also added Section 25206 to the Corporations Code, enabling real estate brokers to engage in the sale of real estate syndicate security interests without having to obtain a broker-dealer license from the Department of Corporations. The legislation also added a provision to the Real Estate Law making it the basis for disciplinary action against a real estate broker if he/she violates certain provisions of the Corporations Code or the regulations of the Corporations Commissioner in transactions involving the sale, exchange or trade of real estate syndicate interests in which the broker is permitted to engage under the Corporations Code. Real Estate Brokers seeking to engage in the sale of security interests in real estate syndicates should also consult Department of Corporations Release No. 62-C (July 2, 1980).

Persons desiring detailed information concerning the offer and sale of interests in real estate syndicates should seek such information from the Department of Corporations.

### **REAL ESTATE INVESTMENT TRUSTS**

A real estate investment trust (REIT) is a trust or corporation that serves as a conduit for the real estate investments of its shareholders.

In 1960, the *Real Estate Investment Trust Act* (Public Law 86-779 - Internal Revenue Code Section 856 et seq.) provided a vehicle by which investors who prefer real estate to security investments could receive substantially the same tax benefits as mutual funds and other regulated investments. Thus, if a REIT distributes 95 percent or more of its ordinary income to shareholders, it is taxed, at corporate rates, on only the retained earnings.

Some of the other advantages which REITs now share with stock investment companies are: (1) pooling of funds to take advantage of big investment opportunities; (2) the best possible legal counsel; and, (3) the added safety and probability of higher returns from widely diversified investment projects.

A REIT is accorded special tax treatment because most of its income is received from real estate and distributed to the shareholders. Along with this tax advantage, REITs are subject to qualifications and limitations, including:

1. Must not hold property primarily for sale to customers in the ordinary course of business.
2. Must be beneficially owned by at least 100 investors.
3. No five, or fewer, persons may hold more than 50 percent of the beneficial interests.
4. The beneficial interest must be evidenced by transferable shares or certificates of interest.
5. In California, each share or certificate of interest must carry with it an equivalent vote.
6. Investments must account for a minimum of 95 percent of the trust's gross income.
7. Seventy-five percent of gross income must come from real estate investments.
8. Less than 30 percent of the trust's gross income may result from short-term gains on sales of stock or securities held for less than six months plus sales (but not involuntary conversions) of real estate held less than four years.
9. Accounting period must be the calendar year.

Because the usual penalty for not meeting the qualifications is the loss of REIT status, it is suggested that licensees contact the IRS for the most current tax law involving REITs.

### Types of REITs

REITs are categorized as equity trusts, mortgage trusts (short-term or long-term) or combination (balanced) trusts.

An **equity trust** owns real property (residential, commercial, or industrial) and its chief source of income is rent. It may buy or construct buildings, develop real estate projects, lease properties, collect rent, and place mortgages on its properties. It is prohibited by law from holding any property primarily for sale to customers. It takes depreciation on its properties and distributes at least 95 percent of its net income to its shareholders.

An equity trust's internal sources of growth capital are refinancing of its mortgage debt and retaining of capital gains when property is sold. External sources are the public sale of its securities, acquisition of properties in exchange for its securities, and short-term bank loans.

**Mortgage trusts** invest their assets in short-term or long-term mortgages or other liens against real property. Their primary source of income is from interest earned from their mortgage portfolios or from commissions and discounts on mortgages purchased.

A short-term mortgage trust's investment objective stresses 6 to 24-month construction and development loans, usually funded through use of commercial paper or bank loans. Maximum profits are realized by continual increase of short-term leverage, thereby netting the spread between the trust's cost of funds and its contractual lending rates.

The investment objectives of a long-term mortgage trust emphasize 20 to 30-year amortized loans, including equity participation loans.

Equity trusts and mortgage trusts both outnumber **combination trusts**, which are able to develop property, own property, lease property, provide mortgage financing and land development loans, etc.

There are many other technical and involved provisions spelled out in federal law, Internal Revenue Service rulings, and the California Corporations Commissioner's regulations. To be properly informed beyond the general picture presented here, licensees should contact the State Department of Corporations.